



# Q & A

## Perspective on Energy

February 2009

### ■ What is River Road's overall view of the Energy sector?

Our investment perspective on the Energy sector is shaped by three fundamental drivers – supply, demand, and company valuations. From a supply perspective, we think global energy producers will struggle to accommodate growing demand. OPEC controls over 40% of the world's oil output and operates with very little spare capacity. An estimated 90% of Saudi Arabia's oil production over the past 30 years has come from just six giant oil fields that now require massive amounts of water to maintain pressure. Non-OPEC production is struggling to grow. The last oil field discovery capable of producing one million barrels per day was Mexico's Cantarell field in 1976. Russia, the world's second largest producer, experienced production declines for the first time in a decade in 2008. Any future growth is likely to be increasingly expensive. The cost to bring a new field on-line in Saudi Arabia, for instance, has tripled since the 1990's.

From a demand perspective, we think fossil fuels will remain critical in meeting global energy needs for the next several decades. According to the Energy Information Agency, fossil fuels will provide 79% of total energy use in the year 2030, compared with 85% today. Despite ambitious alternative energy proposals in the U.S., growing demand from emerging economies should sustain healthy global demand growth for at least a generation. Additionally, the likelihood that the U.S. will substantially decrease its dependence on fossil fuels in the next 10 – 15 years is low. You cannot re-tool a nation's infrastructure that quickly. Although the current economic slowdown has muted near-term energy demand, the trend will almost certainly resume its steady upward trajectory when economic growth normalizes.

Valuations in the Energy sector are also attractive. Historically, energy producers trade between 4 and 10 times cash flow (EV/EBITDA), with an average private market valuation range of 5 to 7 times cash flow. Currently, cash flow valuations are below 5x using what we believe are conservative assumptions for 2009 and 2010.

In summary, we continue to favor energy-related investments. While the recession-induced decline in oil demand has tempered our enthusiasm in the near-term, we expect to find excellent investment opportunities in the sector for years to come.

### ■ Has your view of the Energy sector changed in recent years?

Yes, our perspective began to change in 2002-2003 when two critical factors affected the supply/demand equation. First, in 2003, OPEC spare capacity fell below three million barrels per day for the first time. Since 1970, OPEC had consistently maintained spare capacity in excess of four million barrels per day. For context, the world will consume an estimated 85 million barrels per day in 2009. Second, it became evident to us that the economic and government reforms occurring in larger emerging economies, such as India and China, would drive a sustained increase in demand growth.

Prior to 2002, our energy-related investments were typically small and focused on companies for which our investment thesis had little to do with the price of the underlying commodity. While we still favor those special situation-type energy investments, we are now willing to invest in a broader group of energy companies, including those with a higher level of commodity price sensitivity.

Our perspective on the Energy sector is also relative. In earlier periods, other sectors of the economy simply presented more compelling investment opportunities. In today's investment climate, we believe many energy stocks represent an attractive value and provide positive diversification attributes relative to other investments in the portfolio.



### ■ **How does your perspective differ from more traditional value managers?**

Many traditional value investors avoid energy stocks for two reasons. First, they claim predicting future oil and natural gas prices is inherently difficult. While we agree with this assertion, we feel comfortable with the adaptive, and generally conservative, parameters we use in establishing our price assumptions.

The second reason many value managers avoid energy stocks is that the industry has enormous capital requirements, which limits the generation of consistent free cash flow. We believe there are periods when energy companies generate tremendous free cash flow and represent compelling value. Additionally, we specifically target our research efforts on companies that represent attractive acquisition candidates, have a track record of creating value through successful acquisitions, and/or return cash flow to shareholders in the form of dividends and stock buybacks.

### ■ **How does your team determine its assumptions for the price of oil?**

We combine several measures to arrive at a price assumption. First, we establish a “fair value” range for the price of oil based on the marginal cost of production. The cost of production varies widely around the world, from single digits in Saudi Arabia to \$60 or more in Russia. The Canadian oil sands represent an attractive source of oil, but the break-even cost to bring a new project on-line is an estimated \$80 per barrel. We, of course, assume that a rational producer would eventually curtail production if operating costs exceeded revenues. Thus, depending on fluctuating global demand, we feel confident the fair value of oil over the next several years lies between \$30 and \$90 per barrel.

Second, and most importantly, we analyze the two-year futures price of oil. Our valuation time horizon is typically 12 – 18 months. Thus, we want to know what price a prospective company could theoretically “lock-in” to protect its cash flow during that horizon. As of mid-January 2009, the average oil futures price over the next two years was approximately \$59 per barrel.

Third, we consider the price assumption used by a collection of 25 global energy lenders. As of December 2008, their average oil price assumption over the next two years was \$57 per barrel. Given our near-term outlook for energy demand, we are currently discounting that figure to \$55 per barrel. We believe this is a conservative figure given our longer-term bullish view and current geopolitical disruptions.

### ■ **How do you address the volatility of the underlying commodity?**

Both the demand and supply of oil are inelastic in the short term. Thus, even small changes in either can cause wild price fluctuations. The volatility we experienced during the summer of 2008, however, was unprecedented in our investment careers (which includes our CIO’s experience as an energy analyst dating back to early 1973). Never before have we seen such a rapid rise and subsequent decline in energy prices.

Fortunately, our Absolute Value approach is adaptive. As a result of the heightened volatility, we decided to reduce our energy exposure. We began making that shift in the early summer of 2008. In hindsight, our initial trades were not aggressive enough and we got caught behind the rapidly shifting demand curve. By late summer, however, we recognized the depth of the slowdown and began slashing our energy holdings, which spared us from more significant losses during the fourth quarter of 2008.

### ■ **What was your peak price assumption for oil?**

The peak price assumption we employed for oil in our valuation models was \$85 per barrel, which was during the period in mid-2008 when oil was trading in the spot markets at over \$140. That was also a period when many on Wall Street were predicting near-term prices of \$200 or more.

### ■ **Do you employ the same methodology when establishing an assumption for natural gas?**

Not exactly, but the two are related. Our assumption for natural gas is derived primarily from the energy equivalence ratio of 6x between oil and natural gas. The actual price-equivalent ratio has trended higher over the past 18 years, ranging from 8x in the late 1990s to over 11x in 2008. We employ the more conservative 8x as it more closely aligns to the actual energy equivalent ratio. Dividing 8 into our \$55 per barrel oil assumption equates to roughly \$7 per mcf of natural gas.

We also consider demand and supply issues. We think demand for natural gas in the U.S. will remain high due to its clean qualities and domestic availability. We also think gas producers will shut in their supply at gas prices below \$4 per mcf, providing support for the commodity price.

## ■ How does River Road value an Energy company?

We typically start with conservative projections of production growth and apply our price assumptions and cash flow multiple. Publicly listed energy producers will trade anywhere from 4 to 10 times cash flow (EV/EBITDA), depending on market conditions. In the private market, deals are typically valued between 5 and 7 times cash flow. We adjust our cash flow multiple based on the strength of the balance sheet, management team, production growth, shareholder orientation, and the attractiveness of the firm as an acquisition candidate. In addition to a cash flow valuation, we may also consider an energy firm's PV-10 value (present value of estimated future pre-tax cash flows) and other M&A metrics like EV/proved reserves and EV/daily production.

## ■ What are the primary risks you face in the Energy sector?

A prolonged decline in global energy demand is the primary risk to our model. This year will likely be the second consecutive year of global declines in oil demand - the first such occurrence since 1982/1983. Emerging market demand, particularly in China, led the robust demand growth earlier this decade. Chinese demand plummeted in the latter half of December 2008.

The current situation is not without precedent. Following a decade of rapidly rising prices and steady demand growth, global oil demand finally responded to price spikes in 1979 by dropping a cumulative 10% over four consecutive years and did not fully recover for nearly a decade. We believe the probability of a similar situation occurring today is only moderate, but significant enough for us to limit our absolute exposure in our Small and Small-Mid (SMID) Cap Value portfolios to mid-single digits. We are comfortable with a somewhat higher allocation in our Dividend All-Cap Value (DAV) portfolio because that strategy includes diversified energy investments, such as pipeline partnerships, that pay an attractive dividend yield and have less commodity price sensitivity.

## ■ Based on your outlook for Energy companies, how are you positioning your various strategies?

As previously stated, in our Small and SMID Cap Value strategies we are maintaining a weighting in the mid-single digits. For both strategies, our position is overweight the benchmark, but by a moderate amount. In Small and SMID, we are diversified among oil and gas producers. Our largest energy holding in these strategies has hedged a significant amount of its production at much higher commodity prices for the next few years. We also complement our producers with niche service providers, well-managed refiners, and special situations.

Energy is currently the largest weighted sector in our Dividend All-Cap Value portfolio. The positioning is significantly different from our Small and SMID Cap Value strategies due to the specific opportunity set available among Master Limited Partnerships (MLPs), which represent nearly 60% of our Energy sector holdings in DAV. Our DAV Portfolio also has the dual investment objective of capital appreciation and current income. MLPs are publicly-traded partnerships that are typically focused on investing in energy infrastructure (pipelines, processing, storage, and distribution). The primary attraction of these investments is their high yield. The fundamental health for many of these firms is less dictated by the price of oil or gas than by the quantity of demand. This distinction is demonstrated by the continued dividend increases announced by our holdings.

River Road Asset Management, LLC ("RRAM") is a registered investment adviser formed in April 2005 and is employee owned. RRAM claims compliance with the Global Investment Performance Standards (GIPS®). RRAM maintains a complete list and description of composites and a presentation that complies with the requirements of the GIPS® standards, which is available upon request by contacting Thomas D. Mueller, CPA, CFA at (502) 371-4100 or [thomas.mueller@riverroadam.com](mailto:thomas.mueller@riverroadam.com).

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